

In the United States Court of Appeals  
for the Ninth Circuit

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOE SHOONG, RESPONDENT

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ROSE SHOONG, RESPONDENT

---

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX  
COURT OF THE UNITED STATES

---

BRIEF FOR THE PETITIONER

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THERON LAMAR CAUDLE,

*Assistant Attorney General.*

ELLIS N. SLACK,

ROBERT N. ANDERSON,

FRED E. YOUNGMAN,

*Special Assistants to the Attorney General.*

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PAUL P. O'BRIEN,

**CLERK**

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**OPINION BELOW**

The unreported memorandum findings of fact and opinion of the Tax Court are printed in the record at pages 31 to 37, inclusive.

**JURISDICTION**

These appeals involve deficiencies in Federal income tax for the year 1944 asserted against Joe Shoong and Rose Shoong (hereinafter sometimes referred to as the

taxpayers), in the respective amounts of \$58,441.99 and \$61,841, practically the entire amount of which in each case resulted from the Commissioner's disallowance of deductions claimed by the taxpayers as amortizable bond premium. (R. 31.) The taxpayers are husband and wife residing at Oakland, California. They filed separate income tax returns for the calendar year 1944 with the Collector of Internal Revenue for the First District of California on a community property basis. (R. 32.) Under date of May 14, 1947, the Commissioner of Internal Revenue duly mailed to each a statutory notice of deficiency pursuant to Section 272 of the Internal Revenue Code. (R. 6-10, 14-18.) A petition for review of the Commissioner's determination was filed with the Tax Court by each taxpayer on August 11, 1947. (R. 4-6, 12-14.) On August 9, 1948, the Tax Court entered its decision in each case, reducing the deficiency in the case of Joe Shoong to \$136.63 and in the case of Rose Shoong to \$557.44. (R. 37-38.) The cases are brought to this Court by petitions for review filed by the Commissioner of Internal Revenue under date of October 25, 1948. (R. 39-40, 43-44.) The jurisdiction of this Court is invoked under Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

#### QUESTION PRESENTED

The only question presented in each of these cases is whether, under the facts, the Tax Court erred in allowing as deductions from gross income for the taxable year involved, under Sections 23 (v) and 125 of the Internal Revenue Code, the excess of the amount of the basis (here cost) of certain American Telephone & Telegraph Company 15-year, three per cent convertible debenture bonds over the amount payable on call date prior to maturity.



## STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the applicable statute and Regulations involved are printed in the Appendix, *infra*.

## STATEMENT

These cases were submitted to the Tax Court on a stipulation of facts and exhibits attached thereto (R. 20-31), plus certain other exhibits which were filed at the hearing before the Tax Court (R. 32). The material facts were summarized by the Tax Court as follows:

On June 21, 1944, taxpayer Joe Shoong, purchased American Telephone & Telegraph Company 15-year three per cent convertible debenture bonds due September 1, 1956, as follows (R. 32):

Face Amount—	\$500,000
Basis—	120 $\frac{1}{8}$
Cost—	\$600,625
Commission—	\$1,250
Accrued Interest—	\$4,666.66
Total—	\$606,541.66

In his income tax return for 1944 he reported adjusted gross income of \$104,304.58, and deductions of \$97,533.76, which latter amount included a claim of \$81,879.94 amortization of bond premium on American Telephone & Telegraph Company debenture bonds. The net income reported by taxpayer Joe Shoong for the taxable year was \$6,770.82. (R. 32.)

On June 26 and 27, 1944, taxpayer Rose Shoong, purchased at prices ranging from 120 $\frac{1}{8}$  to 121 $\frac{7}{8}$ , American Telephone & Telegraph Company 15-year three per cent convertible debenture bonds due September 1, 1956, as follows (R. 33):

Face Amount—\$500,000  
 Cost—\$604,348.75  
 Commission—\$1,250  
 Accrued Interest—\$4,902.92  
 Total—\$610,501.67

In her income tax return for 1944 taxpayer, Rose Shoong, reported adjusted gross income of \$100,927.43, and deductions of \$96,235.84, which latter figure included a claim of \$85,607.29 as amortization of bond premiums on American Telephone & Telegraph Company bonds. She reported a net income for the taxable year of \$4,691.59. (R. 33.)

On January 8, 9, and 10, 1945, taxpayer Joe Shoong sold, at prices ranging from 123 $\frac{3}{8}$  to 124, his American Telephone & Telegraph Company debenture bonds, as follows (R. 33):

Face Amount—\$500,000  
 Selling Price—\$617,262.50  
 Interest—\$5,446.32  
 Commission—(\$1,250).  
 Tax—(\$200.05)  
 Ins. & Postage—(\$7.00)  
 Net—\$621,251.77

On January 10, 11, 12, 15, and 16, 1945, taxpayer Rose Shoong sold, at prices ranging from 123 to 123 $\frac{3}{4}$ , her American Telephone & Telegraph Company debenture bonds, as follows (R. 33-34):

Face Amount—\$500,000  
 Selling Price—\$616,522.50  
 Interest—\$5,618.32  
 Commission—(\$1,252.50)  
 Tax—(\$250.45)  
 Net—\$620,637.87

These debenture bonds were issued under an indenture by the American Telephone & Telegraph Company and City Bank and Farmers Trust Company, as



trustee, dated September 1, 1941. This indenture provided that, at any time between January 1, 1942, and December 31, 1954, unless previously called for redemption, the debenture bonds were convertible into the capital stock of the company at a conversion price of \$140 per share, payable by surrender of \$100 principal amount of debenture bonds and payment to the company of \$40 in cash for each share of capital stock to be issued upon conversion. It also provided that the company should have the option to redeem all or part of the bonds after September 1, 1942. The redemption price to and including August 31, 1944, was to be \$107, plus accrued interest, and from August 31, 1944, to and including August 31, 1948, was to be \$104, plus accrued interest. (R. 34.)

The entire issue of the debenture bonds was called for redemption on September 1, 1947, at \$104, plus interest. (R. 34.)

The average price of the capital stock of the American Telephone & Telegraph Company on June 21, 1944, was  $160\frac{1}{2}$  per share; on June 26, 1944,  $160\frac{1}{2}$  per share; and on June 27, 1944,  $160\frac{3}{4}$  per share. (R. 35.)

The price range of these debenture bonds from April 30, 1943, to August 29, 1947, was from  $112\frac{1}{2}$  to  $157\frac{1}{2}$ . The price range of the common stock of the American Telephone & Telegraph Company during the same period was from  $147\frac{1}{4}$  to  $199\frac{5}{8}$ . During the same period the excess in the sale price of the debenture bonds ranged from \$34.75 to \$42. (R. 35.)

During the period April 30, 1943, to November 3, 1944, the selling price of Pacific Gas & Electric Company (Cal.) First Ref.  $3\frac{3}{4}$ s bonds ranged from  $107\frac{7}{8}$  to  $112\frac{7}{8}$ . During the period April 30, 1943, to July 3, 1947, the selling price of Consolidated Edison of New York, Inc., debenture bonds  $3\frac{1}{2}$ s, due April 1, 1956, ranged from  $101\frac{1}{2}$  to  $108\frac{1}{4}$ . Standard and Poor's

Monthly Bond Yield Index Public Utility Bonds Rated A-1 monthly averages during the years 1941 to 1947, inclusive, ranged from 2.583 to 2.925. (R. 35.)

The bonds purchased by the taxpayers were not part of the stock in trade of the taxpayers or includible in any inventory of the taxpayers at the close of the taxable year, or held by the taxpayers primarily for sale to customers in the ordinary course of their trade or business. Taxpayers did not, during the calendar year 1944, sell any of the bonds purchased by them, nor did they exercise their privilege of converting these bonds into capital stock of the company. (R. 35-36.)

In each deficiency notice the Commissioner explained his disallowance of the deduction for amortization of bond premium as follows (R. 35):

The deduction is disallowed since it is held that the amount does not represent amortizable bond premium. It is held that the consideration represents the value of the right to convert the bonds into capital stock of the company.

The taxpayers in reliance upon information that they would be entitled to claim, in the year 1944, a deduction for amortization of the amount by which the cost exceeded the call price, purchased the bonds with the intention of making such a claim for a deduction for amortization and of selling the bonds after holding them for more than six months so that the gain, if any, upon the sale would be subject to tax as long-term capital gain. (R. 36.)

Upon the basis of these facts, and its earlier decision in *Korell v. Commissioner*, 10 T. C. 1001, the Tax Court reversed the Commissioner's determination (R. 36-37), and the Commissioner has appealed from that ruling (R. 39-40, 43-44).

## STATEMENT OF POINTS TO BE URGED

The points relied upon by the Commissioner as a basis for these appeals are as follows (R. 47-50):

1. The Tax Court erred in each case in holding and deciding that the premium paid for bonds callable for redemption on 30 days' notice is amortizable in full in the year of acquisition under Sections 23 (v) and 125 of the Internal Revenue Code, notwithstanding the premium may have been due entirely to accompanying privilege of converting into the obligor's stock at a price below current market value.

2. The Tax Court erred in each case in holding and deciding on the authority of its decision in *Korell v. Commissioner*, 10 T.C. 1001, that the phrase in Section 29.125-5 of Regulations 111 "on a date certain specified in the bond" is a gratuitous addition by the Commissioner not founded upon the statutory language and is directly in conflict with its legislative history.

3. The Tax Court erred in each case in failing to reject the taxpayer's claim for amortization of bond premiums because they were not true bond premiums within the intendment of the statute and Regulations, such as would normally be amortized out of gross interest earnings in order to exclude capital recovered under the guise of interest.

4. The Tax Court erred in each case in failing to hold that the deduction is not within the intendment of the statute and Regulations, for the reason that the purchase of the bonds, the deduction of the bond premiums in full and the sale of the bonds shortly after capital gain rates became applicable, were all parts of a plan of tax avoidance.

5. The Tax Court erred in each case in failing to hold and decide that no part of the so-called premium on

the 15-year, three per cent convertible debenture bonds of the American Telephone and Telegraph Company was deductible in the year 1944 under Sections 23 (v) and 125 of the Internal Revenue Code as amortization of the premium over the call price for the reason that the excess of the purchase price over par represented the market value of the conversion option and was not a true bond premium.

#### SUMMARY OF ARGUMENT

The Internal Revenue Code provides that in computing taxable net income there may be deducted, among other things, the amount of amortizable bond premium applicable to bonds held by the taxpayer. In this case, the taxpayers acquired debentures which were callable before maturity and could have been called during the taxable year, thus making any premium paid for them deductible from gross income of that year. The debentures also could be converted into common stock of the obligor at any time by surrender thereof and payment of an additional cash consideration.

The taxpayers acquired their debentures at a cost which greatly exceeded their face value and which also greatly exceeded the amount at which they could have been called during the taxable year. They deducted this excess over the call price as amortizable bond premium. The Tax Court construed the statute as authorizing this deduction.

It is clear from the facts of the case that the amounts here involved represented consideration paid for the conversion option contained in the debentures. It did not represent true bond premium. It is the contention of the Commissioner that in enacting the provisions of law here involved Congress intended to allow deductions only for amortization of true bond premium, and that the decision of the Tax Court should be reversed.



## ARGUMENT

**The Difference Between Cost and Call Price of the Debentures Here Involved Did Not, under the Facts of Record, Represent "Bond Premium" Within the Meaning of Applicable Provisions of the Statute**

In asserting the deficiencies here involved the Commissioner of Internal Revenue determined that the sum of \$81,879.94 in the case of Joe Shoong and \$85,607.29 in the case of Rose Shoong, representing the difference between the amounts reported as the cost to each<sup>1</sup> of \$500,000 face amount of American Telephone & Telegraph Company convertible debentures issued under the trust indenture of September 1, 1941, described above<sup>2</sup> and the amount<sup>3</sup> at which the indentures could have been called at the earliest date after acquisition by the taxpayers,<sup>4</sup> did not represent "amortizable bond premium" within the meaning of Section 125 of the Internal Revenue Code (Appendix, *infra*) which is deductible under Section 23 (v) of the Code (Appendix, *infra*) in computing taxable net income. The facts here involved are not in dispute. The Tax Court held (R. 36-37) that the amounts here involved were deductible under Section 23 (v) of the Code and the only issue for determination here is the correctness of the Tax Court's decision.

The question here involved is essentially one of statutory construction. The position of the Commissioner is that in enacting Sections 23 (v) and 125 of the Internal Revenue Code, here involved, Congress intended to authorize a deduction for "amortization" only of true bond premium, while the effect of the Tax Court's

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<sup>1</sup> \$601,879.94 in the case of Joe Shoong (R. 9); \$605,607.29 in the case of Rose Shoong (R. 17).

<sup>2</sup> Joint Exhibit A-1 attached to the stipulation of facts (R. 23), but omitted from the printed record by order of the Court (R. 52-53).

<sup>3</sup> \$520,000 in each case. (R. 9, 17.)

<sup>4</sup> Section 3.01, pages 28-29, of Exhibit A-1 attached to the stipulation of facts.

decision is to allow a deduction for any amount paid for a "bond", as defined in Section 125 (d) (Appendix, *infra*), in excess of the amount for which it was callable or retirable regardless of what that excess expenditure actually represented.<sup>5</sup>

The decisions in these cases are based upon the Tax Court's earlier decision in *Korell v. Commissioner*, 10 T. C. 1001, which is now pending on appeal by the Commissioner to the Court of Appeals for the Second Circuit, and which involves a similar transaction in the same debentures.<sup>6</sup> Hence it is necessary to look to the opinion of the Tax Court in the latter case for the reasoning upon which the decisions in the instant cases are based.<sup>7</sup>

Sections 23 (v) and 125 were added to the Internal Revenue Code by Section 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798. Section 23 (v) authorizes a

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<sup>5</sup> Deductions from gross income and exemptions from tax are granted only as a matter of legislative grace and statutes granting such deductions or exemptions are to be strictly construed. This being a claim for deduction from gross income, the burden is upon the taxpayer to bring himself squarely within the provisions of the statute. *Helvering v. Northwest Steel Mills*, 311 U. S. 46, 49; *Deputy v. du Pont*, 308 U. S. 488, 493; *New Colonial Co. v. Helvering*, 292 U. S. 435, 440; *Ilfeld Co. v. Hernandez*, 292 U. S. 62, 66; *Woolford Realty Co. v. Rose*, 286 U. S. 319, 326; *Burnet v. Houston*, 283 U. S. 223, 227.

<sup>6</sup> These seem to be the only cases to date involving the application of Sections 23 (v) and 125 of the Internal Revenue Code to facts similar to the facts here involved, hence the question is one of first instance.

<sup>7</sup> While *Korell v. Commissioner*, *supra*, involved a similar transaction in the same issue of debentures, the findings in that case are not as complete as in the instant case and the record does not disclose as clearly as this one the basis of the Commissioner's contention. The findings in that case do not disclose the time or nature of the taxpayer's disposition of his debentures; does not show the market value of securities of similar desirability; and does not show that the transaction was entered into primarily for claiming a tax deduction.



deduction for amortizable bond premiums as provided in Section 125. Briefly, so far as material here, Section 125 provides for amortization of bond premium out of gross interest earnings in order to exclude from gross income capital recovered under the guise of interest and thus truly reflect the income realized from an investment in bonds at a premium.

As the Tax Court points out at the beginning of its opinion in the *Korell* case, *supra*, when the coupon rate of interest carried by a bond issue exceeds the going interest rate for obligations of comparable desirability, the market will tend to place a premium on such bonds. If bonds are purchased for investment under such circumstances the premium paid must be recovered tax-free out of the earnings of the bond, very much as depreciation must be recovered out of the income of depreciable property, if the true distinction between income and recovery of capital is to be preserved. To effect this result is the obvious purpose of Section 125 of the Internal Revenue Code. And the matter would seem to be simple in the case of an ordinary bond with a fixed maturity date. But, as the Tax Court there pointed out, the matter becomes complicated in the case of a bond which is callable before maturity, or is convertible into other securities before maturity, or both as in the instant case.

The statute (Sec. 125 (b) (2), (Appendix, *infra*)), provides that the amortizable bond premium of the taxable year "shall be the amount of the bond premium attributable to such year." So far as material here, it provides (Sec. 125 (b) (1), (Appendix, *infra*)), that the "amount" of bond premium shall be determined with reference to the amount of the "basis" (here cost), and with reference to the amount payable "on maturity

or on earlier call date.”<sup>8</sup> Otherwise, no provision is made in the case of bonds which may also be convertible into other securities, but the respective Congressional Committee reports indicate that the amortization allowance also applies to *premium* paid on bonds with convertible features. See H. Rep. No. 2333, 77th Cong., 2d Sess., p. 80 (1942-2 Cum. Bull. 372, 433-434), and S. Rep. No. 1631, 77th Cong., 2d Sess., p. 94 (1942-2 Cum. Bull. 504, 576). As will be seen later, the question here is not so much the applicability of Section 125 of the Code as it is whether the amounts here involved constitute “bond premium” within the meaning of the statute.

Section 125 (b) (3) of the Code (Appendix, *infra*) provides that the amortizable amount shall be computed either in accordance with the method of amortizing bond premium regularly employed by the holder of the bond if such method is reasonable (which apparently was not the situation in this case), or “in accordance with regulations prescribing reasonable methods of amortizing bond premium”, prescribed by the Commissioner with the approval of the Secretary of the Treasury.

Section 29.125-5 of Regulations 111 (Appendix, *infra*) provides that “The fact that a bond is callable or

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<sup>8</sup> In its opinion in the *Korell* case, *supra*, the Tax Court said (pp. 1003-1004):

A complication bound to arise was the amortization of premium on bonds callable prior to maturity. Such obligations *although not included in the statute* are covered in a subdivision of the regulations dealing with “Callable and Convertible Bonds.” (Italics supplied.)

But from the above-quoted language of the statute it is clear that bonds callable before maturity were included, leaving for the Commissioner the duty to prescribe Regulations under which the period of amortization would be determined. This was done in the paragraph of the Regulations (Regulations 111, Sec. 29.125-5 (Appendix, *infra*)), referred to by the Tax Court in the *Korell* case, *supra*.

convertible into stock does not, in itself, prevent the application of section 125." With respect to callable bonds this section of the Regulations provides:

For the purposes of such section [Section 125], in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. \* \* \*

All the Regulations (Sec. 29.125-5) say with respect to convertible bonds is that "A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof." But the Regulations do not mention situations such as here involved where the bond is convertible by the holder at his option at any time before it is called, rather than "on a date certain specified in the bond." Nor is anything said about what would be the "due date" of a convertible bond within the meaning of the statute where, as here, the bond is convertible at any time at the option of the holder where no "date certain" is specified in the bond.

In its opinion in the *Korell* case, *supra*, the Tax Court held that the above sentence in the Regulations, "whatever its meaning may be", could not apply here because the bonds involved, which were of the same issue as in the instant case, were convertible at the option of the holder "on any date from the minute he acquired them." It went further and said that the words "on a date certain specified in the bond" (pp. 1006-1007)—

appear to be a gratuitous addition by respondent not founded upon the statutory language and directly in conflict with its legislative history. We are accordingly unable to ascribe to it the validity which would result in authorizing respondent's position in this proceeding.

The "legislative history" referred to by the Tax Court in the *Korell* case, *supra* (p. 1006), is the following statement found in the reports of the House Ways and Means Committee (H. Rep. No. 2333, *supra*, p. 80) and Senate Committee on Finance (S. Rep. No. 1631, *supra*, p. 94) :

The fact that a bond is callable or convertible into stock does not of itself prevent the application of this section. In the case of a callable bond, the earliest call date will, for the purposes of this section, be considered as the maturity date. Hence, the total premium is required to be spread over the period from the date as of which the basis of the bond is established down to the earliest call date, rather than down to the maturity date. In the case of a convertible bond, *if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of this section.* (Italics supplied.)

The above provision of Section 29.125-5 of the Regulations, that a convertible bond is within the scope of Section 125 of the Code if the option to convert "on a date certain specified in the bond" rests with the holder thereof, does not necessarily exclude bonds convertible at any time by the holder, and, to the extent that the Tax Court's decision purports to hold the Regulations invalid, it in turn is gratuitous. The Commissioner's disallowance of the deductions claimed in these cases was not specifically based upon this or any other provision of the Regulations. The deductions in controversy were disallowed on the ground that the amounts in question were not *true bond premium* within the meaning of the statute. Instead, they represented consideration paid for the conversion privilege acquired with the bonds. (R. 36.)

That the excess of the price paid for the bonds here involved over their face value represented the cost of



the conversion rights can not successfully be denied. The amount paid for the bonds, including the consideration paid for the conversion rights, plus the \$40 additional payable upon conversion, approximately equalled the current value of the capital stock of American Telephone & Telegraph Company into which the debentures could be converted. That the excess in cost over face value of the debentures here involved represented consideration paid for the conversion privilege is further emphasized by the Tax Court's findings (R. 35) with respect to the current selling price of other public utility bonds of comparable investment desirability, but without similar conversion rights, which sold at comparatively small premiums during this period. Furthermore, it would be naive to assume that the bonds here involved were purchased at such exorbitant prices for purely investment purposes.

That the transactions here involved were entered into primarily for tax saving purposes is clear from the Tax Court's findings (R. 33-34) that in January, 1945, more than six months after the dates of purchase, these debentures were resold by the taxpayers at prices approximating their cost, and the further finding (R. 36) that the taxpayers, in reliance upon information that they would be entitled to the deductions here claimed, purchased the debentures with the intention of claiming such deductions and of selling the bonds after holding them more than six months so the gain, if any, upon the sale, would be taxable as long-term capital gain. Surely, the deductions here sought do not represent a tax-free recovery of an investment out of the earnings of the debentures, much as depreciation is recovered out of the income of depreciable property and if, as the Tax Court said in the *Korell* case, *supra* (p. 1003), this was the purpose of Congress in enacting Sections 23 (v)

and 125 of the Internal Revenue Code, the deductions here can not be justified under the statute.

In its opinion in the *Korell* case, *supra*, the Tax Court seems to recognize that the amount claimed as a deduction did not represent true bond premium. In addition to pointing out (p. 1003) that when the coupon rate of interest exceeds the going rate of interest for obligations of comparable desirability the market will tend to place a premium on such bonds, and that if bonds are purchased for investment under such circumstances the premium paid must be recovered tax-free out of the earnings of the bond very much as depreciation must be recovered out of depreciable property income if the true distinction between income and recovery of capital is to be preserved, the Tax Court (p. 1005) cited and quoted from Badger, *Valuation of Industrial Securities* 42,<sup>9</sup> to the effect that the value of convertible bonds is, in fact, dependent on either one of two factors. As long as the issue into which the bond is convertible remains below the point where conversion is profitable, just so long will the value of the bond be dependent entirely on its investment status. But when the value of the issue into which the bond is convertible rises, the value of the convertible bond reflects both the rate of conversion and the value of the issue into which it can be converted. The formula quoted from "Valuation of Industrial Securities" is at least significant when considered in the light of the facts of this case.

In these cases the taxpayers purchased the debentures in question at approximately \$121 when the common stock into which they could have been converted was selling for approximately \$160.50 per share. (R. 32, 33, 35.) The debentures were currently callable by Ameri-

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<sup>9</sup> See also Badger & Cushman, *Investment Principles and Practices* (1941) 195-202, 746-754.



can Telephone & Telegraph Company on thirty days' notice at \$104. (Joint Ex. A-1, Sec. 3.01, pp. 28-29.) They were convertible at any time by the holder by surrender of the debenture and payment of an additional \$40 in cash. (Joint Ex. A-1, Sec. 4.01, pp. 32-33.) In this situation the Tax Court admitted in its opinion in the *Korell* case, *supra* (pp. 1005-1006), that "in the present case, both the call price and the conversion figures indicate that the premium was paid, not for the investment feature of the bond, but for the right of conversion." This being true, the question involved is whether the Tax Court was correct in holding that Sections 23 (v) and 125 of the Internal Revenue Code permit the deduction, under the guise of "bond premium", of amounts admittedly paid as consideration for features other than the investment features of the bonds. We submit there is nothing in the statute or its legislative history to justify any such interpretation.

The statute obviously does not authorize the deduction of something which is not true bond premium. Section 125 (b) (2) of the Code limits the deduction for a taxable year to "the amount of the bond premium attributable to such year", and under paragraph (1) of that subsection, the amount of the bond premium is the difference between the "basis" of the bond in the hands of the holder for purposes of computing loss on the disposition thereof and the amount payable on maturity or earlier call date.

In this situation we submit the statute should be construed as allowing deductions only for amortization of true bond premium. This construction would be in harmony with the rule applied in *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, involving the deductibility of interest paid on indebtedness, where the Supreme Court said (p. 560) the legislature must be presumed to have used the terms "all interest \* \* \* on its in-

debtedness" in their known and ordinary signification. See also *McClain v. Commissioner*, 311 U. S. 527.

As early as February 17, 1945, the Commissioner, in a special ruling <sup>10</sup> held with respect to this same issue of American Telephone & Telegraph debentures that the difference between the cost thereof and the amount for which they could be called at the earliest call date could not be deducted as amortizable bond premium because the market clearly indicated that substantially all of the amount paid over the face value of the debentures represented the market value of the conversion option rather than true bond premium. We submit this is a reasonable interpretation of the matter.

The Tax Court apparently based its interpretation of the statute upon the above quoted excerpt from the respective Reports of the Ways and Means Committee of the House and of the Committee on Finance of the Senate made in connection with the provisions here under consideration.<sup>11</sup> The Tax Court, after italicizing the last part of the above excerpt said in its opinion in the *Korell* case, *supra* (p. 1006), it "is unequivocal and precisely includes the bonds in controversy." It added: "Petitioner's application of the provision to his situation and his computation of the deduction are thus squarely justified by the expression of congressional intent." But we cannot agree with this conclusion. The statement that a bond which is convertible at the option of the owner is within the purview of the statute does not militate against the Commissioner's position. Bonds which are within the purview of the statute are defined in Section 125 (d) of the Code (Appendix, *infra*) as "any bond, debenture, note or certifi-

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<sup>10</sup> See 1945 P-H, par. 76, 157, and 1945 C.C.H., par. 6139, quoted at length in footnote 5 of the Tax Court's opinion in the *Korell* case, *supra*, p. 1005.

<sup>11</sup> H. Rep. No. 2333, *supra*, p. 80; S. Rep. No. 1631, *supra*, p. 94.

cate or other evidence of indebtedness" issued by any corporation and bearing interest (including interest-bearing government obligations), with interest coupons or in registered form, but do not include any such obligation which constitutes stock in trade of the taxpayer, or which would properly be included in the inventory of the taxpayer, or which is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. So far as the question here involved is concerned, it may be assumed that the debentures of American Telephone & Telegraph met this definition of the statute, but that does not mean that amounts paid for the conversion option in such bonds are amortizable bond premium within the meaning of the statute. The situation would be different if the amounts involved represented true bond premium paid for desirable investment features of the debentures.

#### CONCLUSION

The decision of the Tax Court is wrong. It is contrary to the facts and the law and should be reversed and remanded with directions to enter judgment for the Commissioner of Internal Revenue.

Respectfully submitted,

THERON LAMAR CAUDLE,  
*Assistant Attorney General,*  
 ELLIS N. SLACK,  
 ROBERT N. ANDERSON,  
 FRED E. YOUNGMAN,  
*Special Assistants to the*  
*Attorney General.*

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## APPENDIX

## Internal Revenue Code:

## SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

\* \* \* \* \*

(v) [as added by Sec. 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Bond Premium Deduction*.—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

\* \* \* \* \*

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 125 [as added by Sec. 126 of the Revenue Act of 1942, *supra*]. AMORTIZABLE BOND PREMIUM.

(a) *General Rule*.—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

(1) *Interest wholly or partially taxable*.—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *Interest wholly tax-exempt*.—In the case of any bond the interest on which is excludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *Adjustment of credit in case of interest partially tax-exempt*.—In the case of any bond the interest on which is allowable as a credit against net income, the credit provided in section 25(a)(1) or (2), or section 26(a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year.



(For adjustment to basis on account of amortizable bond premium, see section 113(b)(1)(H).)

(b) *Amortizable Bond Premium.*—

(1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

(c) *Election on Taxable and Partially Taxable Bonds.*—

(1) *Eligibility to elect and bonds with respect to which election permitted.*—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) *Partially Tax-Exempt.*—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25(a)(1) or (2) is allowable; and

(B) *Wholly Taxable.*—In the case of any taxpayer, bonds the interest on which is not excludible from gross income but with respect to which the credit provided in section 25(a)(1) or (2), or section 26(a), as the case may be, is not allowable.

(2) *Manner and effect of election.*—The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such election. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

(d) *Definition of Bond.*—As used in this section, the term “bond” means any bond, debenture, note, or certificate or other evidence of indebted-



ness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(26 U.S.C. 1946 ed., Sec. 125.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.125-1. *In General.*—(a) *Application.*—Section 125 makes provision for the amortization of bond premium by the owners of the bonds. It is mandatory with respect to—

\* \* \* \* \*

It is optional, at the election of the taxpayer, with respect to—

(1) fully taxable bonds (the interest on which is subject to normal tax and surtax), whether the owner is a corporation, individual, or other taxpayer; and

(2) partially tax-exempt bonds owned by taxpayers other than corporations.

The term “bond” as used in section 125 means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any

such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Since bonds owned by dealers in securities are excluded from the foregoing definition, section 125 has no application to such dealers.

(b) *Operation.*—In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bonds. Thus, if such premium is \$1, the basis or adjusted basis of the bond is reduced by \$1. No deduction is allowable on account of such amortizable bond premium. In the case of a fully taxable bond to which section 125 is applicable, the amortizable bond premium is both an adjustment to the basis or adjusted basis of the bond and a deduction.

\* \* \* \*

Sec. 29.125-2. *Bond Premium and Amortizable Bond Premium.*—Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. (For determination of applicable call date see section 29.125-5.) If the date as of which such basis of the bond was established precedes the first taxable year with respect to which such section applies to the bond, there shall be made adjustments proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117(h)) prior to the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer.

\* \* \* \*

Amortizable bond premium on any bond to which section 125 applies is such part of the bond premium on the bond as is attributable to the taxable year.

Sec. 29.125-3. *Methods of Amortization*.—The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(a) the method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(b) the method of amortization prescribed by this section.

A method of amortization will be deemed “regularly employed” by a taxpayer if the method was consistently followed in taxable years beginning prior to January 1, 1942, or if for taxable years beginning on or after such date the taxpayer (including a taxpayer who followed a different method in taxable years beginning prior to January 1, 1942) initiates in the first taxable year for which the deduction is taken a reasonable method of amortization and consistently follows such method thereafter. \* \* \*

The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with section 29.125-2 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this

section a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

Sec. 29.125-4. *Election*.—In the case of a corporation, the election provided in section 125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable year. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. \* \* \*

Sec. 29.125-5. *Callable and Convertible Bonds*.—The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date,

rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof.

